

STAFF PAPER

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Project	Conceptual Framework		
Paper topic	Measurement: Factors to consider when selecting a measurement basis		
CONTACT(S)	Andrew Lennard	alennard@ifrs.org	+44 (0)20 7246 6930
	Rachel Knubley	rknubley@ifrs.org	+44 (0)20 7246 6904

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Purpose of paper

1. Some respondents to the Exposure Draft *Conceptual Framework for Financial Reporting* (the Exposure Draft) expressed the view that Chapter 6—Measurement failed to provide adequate guidance for the development of accounting standards. Most of these respondents agreed that the *Conceptual Framework* should not require the use of a single measurement basis, that the bases discussed were appropriate and that the selection of a measurement basis should be based on the objective of financial reporting and the qualitative characteristics of useful financial information. However, respondents said the link between the sections 'measurement bases and the information that they provide' (paragraphs 6.4–6.47) and 'Factors to consider when selecting a measurement basis' (paragraphs 6.48–6.63) was not sufficiently clear.
2. Clarification will require some revision of both these sections. The most significant changes should be to 'factors to consider when selecting a measurement basis'. In particular, it should be possible, at least for some of the factors, to describe more explicitly their implications. This is the focus of this paper.
3. We also believe that it is necessary to consider a possible change to the classification of current cost as a 'historical cost' measurement basis.
4. Accordingly, this paper discusses:

- (a) where the discussion of current cost should be located in the measurement chapter (paragraphs 9–16); and
 - (b) how the discussion in the *Conceptual Framework* might be improved to provide a better link between the discussion of measurement bases, the information they provide and the factors to consider when selecting a measurement basis (paragraphs 17–47).
5. Paragraphs 48–50 note that the staff propose that the *Conceptual Framework* should retain the points that:
- (a) when selecting a measurement basis, the information provided in both the statement of financial position and the statement(s) of financial performance should be considered;
 - (b) the selection of a measurement basis is subject to the cost constraint; and
 - (c) measurement uncertainty may affect the selection of a measurement basis.
6. As the Exposure Draft noted in paragraph 6.48: ‘the relative importance of each of the factors will depend upon facts and circumstances’. For this reason, a single factor considered in isolation cannot identify the sole measurement basis that must be used in a given situation. We can say that consideration of a particular factor might suggest a measurement basis is likely or unlikely to be relevant, but it should be clear that other factors might point to a different conclusion.

Summary of staff recommendations

7. Staff recommend that the measurement chapter of the *Conceptual Framework* should:
- (a) include a description of the information provided by current cost and a discussion of the advantages and disadvantages of current cost, but that this should be placed under the heading of ‘current value’ rather than ‘historical cost’.
 - (b) state that a factor to consider when selecting a relevant measurement basis is the characteristics of the asset or liability, including the sensitivity of the value of the item to changes in market factors or other risks, and;

- (i) state that where the variability in value is significant; a current value measurement basis is likely to be more relevant than the historical cost basis;
 - (ii) explain the reasons why current value is likely to be more relevant than historical cost when variability in value is significant;
 - (iii) identify cases where the characteristics of an asset or liability would suggest a current value for an asset or liability.
- (c) state that a factor to consider when selecting a relevant measurement basis is the contribution of the asset or liability to future cash flows and;
- (i) state that a cost measurement basis is likely to provide relevant information for revenue generating assets and liabilities—that is those held for use in producing goods and services for customers;
 - (ii) state that for assets (liabilities) that produce (require) cash flows directly, a measurement basis that reflects a current value such as fair value is likely to provide relevant information; and
 - (iii) explain the rationale for these statements.
- (d) retain the discussion in the Exposure Draft of faithful representation and the enhancing qualitative characteristics, but should not attempt to provide examples of their implications in specific cases.
8. These recommendations are consistent with the Exposure Draft—they merely express the underlying thought processes more clearly. Any new thoughts are simply explicit statements of what was implicit in the Exposure Draft.

Measurement bases—location of current cost

Exposure Draft proposals

9. The Exposure Draft discussed measurement bases under two main headings—‘historical cost’ and ‘current value’. The discussion of historical cost included the following paragraph on current cost (paragraph 6.18):

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Current cost and historical cost are both entry values (ie they reflect values in the market in which the entity acquires the asset or incurs the liability). Hence, they are different from the current value measurement bases described in paragraphs 6.19–6.46.

10. The Basis for Conclusions on the Exposure Draft explained that a detailed discussion of current cost was unnecessary because the Board would be unlikely to consider it when developing future Standards (paragraph BC6.23).
11. Some respondents pointed out that it was illogical to discuss current cost under the heading of ‘historical cost’. Some also objected that no conceptual basis was given for the dismissal of current cost.

Staff analysis and recommendation

12. Staff agree it is illogical to discuss current cost within a discussion headed ‘historical cost’. This problem could be addressed by:
 - (a) deleting the discussion of current cost;
 - (b) changing section titles. For example, the headings:
 - (i) ‘historical cost’ could be changed to ‘cost’ or ‘entry value’;
 - (ii) ‘current value’ could be changed to ‘other value’ or ‘exit value’; or
 - (c) moving the discussion of current cost under the ‘current value’ heading.
13. Deleting the discussion of current cost would be straightforward and might have insignificant practical disadvantages, as it is perhaps difficult to foresee that it will be widely used in Standards. But the future is unknown—current cost might be a useful concept when the Board considers, for example, a Standard on extractive industries. Moreover, current cost is a concept that is widely discussed in the academic and professional literature and has strong conceptual advantages (as well as disadvantages). In particular, it is at least arguable that performance reported on a current cost basis is more likely to have predictive value than information reported on a historical cost basis as future prices are more likely to resemble recent prices than those incurred at some time in the past. Also, as noted in the existing *Conceptual*

Framework (paragraph 4.61) it would be necessary to adopt current cost if a physical capital maintenance concept were to be used. (We plan to bring a paper on Capital Maintenance to a future Board meeting.)

14. Changing the section headings does not seem attractive. The heading ‘other value’ would not be meaningful for the bases currently discussed under ‘current value’—fair value, value in use and fulfilment value. In addition, although a few respondents suggested the *Conceptual Framework* should include a discussion of entry value and exit value, introducing those terms might be viewed as a significant departure from the Exposure Draft.
15. As ‘current cost’ is a current measure it is more naturally categorised as a current rather than historical measurement basis.
16. If the *Conceptual Framework* includes a discussion of current cost, it should set out the disadvantages of using current cost as well as the conceptual advantages. The disadvantages include:
 - (a) applying current cost can be complex and subjective in many common circumstances;
 - (b) there is little information content in reporting all changes in current cost as income and expenses without disaggregation. It provides useful information only if the cost of consumption is reported separately from holding gains. Making this distinction can be difficult and require the use of arbitrary assumptions; and
 - (c) stating some items at current cost and others at historical cost may affect coherence and understandability.

Question 1

We recommend that the *Conceptual Framework* should include a description of the information provided by current cost and a discussion of the advantages and disadvantages of current cost, but that this should be placed under the heading of current value rather than historical cost.

Do you agree?

Characteristics of the asset or liability

Exposure Draft proposals

17. The Exposure Draft discussed in paragraph 6.54(b) some factors that should be considered in selecting a relevant measurement basis, including the ‘characteristics of the asset or liability’ which was expressed as:

the characteristics of the asset or the liability (for example, the nature or extent of the variability in the item’s cash flows, or the sensitivity of the value of the item to changes in market factors or to other risks inherent in the item).

18. However, the Exposure Draft did not explicitly describe how the consideration of this factor might affect the conclusion reached.

Feedback from respondents

19. Most respondents supported the Exposure Draft’s discussion of the factors to consider when selecting a measurement basis. However:

- (a) The Accounting Standards Board of Japan expressed the view that the *Conceptual Framework* should not identify the characteristics of the asset or liability as a factor to consider when selecting a measurement basis. They suggested that a measurement basis should be selected purely on the manner of its contribution to cash flows. Although they agreed that the characteristics of an asset or liability are important, they suggested that they influence the determination of how the asset or liability contributes to future cash flows. They explained how this approach might lead to a different selection depending on whether the selection is made for the purpose of reporting financial performance or financial position.
- (b) Another standard-setter (the UK Financial Reporting Council) said the Exposure Draft failed to explain why the characteristics of the asset, particularly sensitivity to changes in value, were relevant, because the Exposure Draft did not discuss the notion of value.

Staff analysis and recommendation

20. The key idea underpinning this factor would seem to be variability in value. A historical cost measurement may be less likely to provide the most relevant information about assets and liabilities that are subject to significant changes in value.
21. To explain that conclusion, the Board could add to the *Conceptual Framework* that where assets and liabilities are subject to significant changes in value:
- (a) historical cost might be significantly different from the value of the asset or liability at the reporting date. The value of assets or liabilities at the reporting date would be most relevant in providing information that helps users to assess the features identified in paragraph 1.13 of the Exposure Draft:
 - (i) the reporting entity's financial strengths and weaknesses;
 - (ii) the entity's liquidity and solvency;
 - (iii) the entity's need for additional; financing and how successful it is likely to be in obtaining that financing; and
 - (iv) management's stewardship of the reporting entity's economic resources.
 - (b) if historical cost is used, changes in value would not be reported when prices change, but only when the asset or liability was disposed of (derecognised). This might also distort the income and expenses that arise in the period of disposal (settlement) as it would imply that all the income or expenses arose in that period, rather than in the periods during which the asset or liability was held.
 - (c) if historical cost is used, the financial statements would fail to communicate the entity's exposure to risk arising from holding the asset or liability.
22. The Board might add to the *Conceptual Framework* a comment that cases where the characteristics of an asset or a liability would suggest a current value for an asset or liability could include:
- (a) assets and liabilities of operations conducted in economies of high inflation;

- (b) assets and liabilities subject to frequent price changes, such as commodities, equity investments and derivatives; and
 - (c) long-lived assets that are likely to be held for significant periods of time.
23. As expressed in the Exposure Draft, the ‘characteristics of the asset’ factor suggests that variability in cash flows need to be considered. While in many cases variability in cash flows would imply variability in value, this is not always the case. The cash flows of a floating rate loan, for example, vary as interest rates change, but the value of the loan does not. For this reason, we think that reference to variability in cash flows is confusing and that the reference to variability in cash flows should be deleted from the factor.

Question 2

We recommend that the *Conceptual Framework* should state that a factor to consider when selecting a relevant measurement basis is the characteristics of the asset or liability, including the sensitivity of the value of the item to changes in market factors or other risks, and:

- (a) state that where the variability in value is significant; a current value measurement basis is likely to be more relevant than the historical cost basis;
- (b) explain the reasons why current value is likely to be more relevant than historical cost when variability in value is significant; and
- (c) identify cases where the characteristics of an asset or liability would suggest a current value for an asset or liability.

Do you agree?

Contribution to cash flows

Exposure Draft proposals

24. Contribution to cash flows was another factor the Exposure Draft identified as important to consider in relation to the relevance of a measurement basis (paragraph 6.54). It was expressed as:

To produce relevant information, it is important to consider [...] when selecting a measurement basis for an asset or liability and the related income or expense how that asset or liability

contributes to future cash flows. This will depend in part on the nature of the business activities conducted by the entity. For example, if a property is realised by sale, it will produce cash flows from that sale, but if a property is used in combination with other assets to produce goods and services, it will help produce cash flows from the sale of those goods and services.

25. The distinction made here is similar to that in paragraph 1.14 of the Exposure Draft, which states:

Different types of economic resources affect a user's assessment of the reporting entity's prospects for future cash flows differently. Some future cash flows result directly from existing economic resources, such as accounts receivable. Other cash flows result from using several resources in combination to produce and market goods or services to customers. Although those cash flows cannot be identified with individual economic resources (or claims), users of financial reports need to know the nature and amount of the resources available for use in a reporting entity's operations.

26. Although the Exposure Draft was not explicit, the broad implications of the contribution to cash flows factor would seem to be:
- (a) for assets that produce cash flows directly, and for liabilities that will directly require cash outflows a current value is likely to be more relevant; and
 - (b) in contrast, for assets and liabilities that are used in combination with other assets to produce and market goods or services to customers a historical cost measurement is likely to be more relevant.

Feedback from respondents

27. Some respondents specifically supported the suggestion that how an asset or liability contributes to future cash flows was an important factor to consider when selecting a measurement basis. Many of these supported the reference to 'business activities' and suggested that the idea of 'business activities' should be more prominent in the discussion of measurement, or even the primary factor. In a few cases, this support was specifically within the context of measurement of income and expenses.

However, a few respondents were more limited in their support for the idea of ‘business activities’, suggesting that it should be subordinated to other factors in some cases.

28. A few respondents opposed the reference to business activities within the context of measurement. One of the main concerns was that it would lead to a loss of comparability.

Staff analysis and recommendation

Clarifying the ‘contribution to cash flows’ factor

29. The factor as set out in the Exposure Draft seems to combine a number of ideas:

- (a) the nature of the entity’s business activities;
- (b) whether the asset will be sold or will be used to produce goods and services; and
- (c) whether the asset is used in combination with other assets.

30. There would seem to be an opportunity to enhance clarity by distinguishing the principle from supporting discussion. For example, the principle could be stated as distinguishing:

- (a) ‘revenue-generating assets’—assets (and liabilities) held for use in producing goods and services for customers; and
- (b) assets (and liabilities) that produce (require) cash flows directly.

31. The reference to ‘customers’ is used in this paper in the same sense as it is defined in IFRS 15 Revenue from Contracts with Customers. The IFRS 15 definition includes reference to the entity’s ordinary activities, it, therefore, incorporates the idea that an entity’s business activities are important in determining how an asset or liability contributes to future cash flows. This idea was important to many respondents. We plan to bring a paper discussing the role of an entity’s business activities in financial reporting to a future Board meeting.

32. The supporting discussion might note that revenue-generating assets are generally used in combination with other assets. It might also note that the distinction between

revenue-generating assets and other assets can usually be made on objective evidence: it is not dependent merely on management's intent.

Implications of the 'contribution to cash flows' factor

33. The *Conceptual Framework* could explain that a cost measurement basis is likely to provide relevant information about revenue-generating assets and revenue-generating liabilities. This is because it enables users to compare revenue with the cost of the assets consumed in earning that revenue—in other words, it enables reporting of the margin earned on revenue-generating operations and components of that margin¹. Users generally want to estimate what margins an entity will generate from revenue-generating operations over its entire life. Users are therefore not primarily interested in the amount that would be obtained if the asset were sold, which is the information provided by fair value.
34. In contrast, for assets (liabilities) that produce (require) cash flows directly, a measurement basis that reflects a current value such as fair value is more likely to provide the most relevant information, as it provides information that reflects the current value of the amount, timing and uncertainty of future cash flows. Income or expenses that arise when such items are sold or settled is unlikely to have great predictive value.
35. It is probably necessary to add a brief discussion of inventory, as inventory might be thought to be held for sale. However, inventory is usually held with a view to providing goods or services to customers, which requires a selling effort and is subject to the risk of not finding a customer. In contrast, for inventory such as readily tradable commodities, no significant selling effort is required and there is no significant risk of not finding a customer. Such inventory could be regarded as held for the purpose of benefiting from price changes, and a current value is likely to provide the most relevant information about the entity's success in benefiting from past price changes. Moreover, in such cases, users are unlikely to wish to estimate future margins in the same way as for non-commodities.

¹ The Exposure Draft already notes the importance of information on margins in its discussion of historical cost.

36. Similar considerations apply to the lending and deposit-taking activities of financial institutions. In many cases, users wish to estimate the margins that a financial institution will earn over its entire life from the difference between interest paid on its deposits and interest received on its loans and receivables. To make those estimates, users often wish to receive information about the margin arising in the past between contractual interest earned on the institution's loans and receivables and interest paid and payable on its deposits, as well as information about loan impairments. An amortised cost measurement basis provides that information. However, amortised cost does not provide information about:
- (a) the price that an entity would receive if it were to sell the loans or receivables immediately after the reporting date, or that it would need to pay to transfer its deposits at that time;
 - (b) the effect of changes in the price for bearing uncertainties inherent in the cash flows (ie a risk premium or discount, as discussed in paragraph A2 of the Appendix A to the Exposure Draft)²;
 - (c) for deposits, changes in the effect of the possibility that the entity may fail to fulfil the liability (own credit risk);
 - (d) changes in the prices for factors such as liquidity if market participants or others would take those factors into account in determining the price they would willingly pay or receive for the asset or liability; and
 - (e) the effect of mismatches between the duration of loans and receivables, and the duration of deposits. As interest rates change, a current value measurement basis leads to the recognition of gains or losses that depict those duration mismatches. Those gains and losses also give an indication of how net cash flows may change if the interest rates ruling at the end of the reporting period continue throughout the remaining life of the existing

² Nevertheless, amortised cost does provide information about changes in estimates of future cash flows resulting from impairment.

loans, receivables and deposits, even if the entity does not sell or transfer them.

37. When users are likely to be interested in the information mentioned in paragraphs 36(a)–(e), a current value measurement basis is likely to be more relevant.

Question 3

We recommend that the *Conceptual Framework* should state that a factor to consider when selecting a relevant measurement basis is the contribution of the asset or liability to future cash flows; and

(a) state that a cost measurement basis is likely to provide relevant information for revenue generating assets and liabilities—that is those held for use in producing goods and services for customers;

(b) state that for assets (liabilities) that produce (require) cash flows directly, a measurement basis that reflects a current value such as fair value is likely to provide relevant information; and

(c) explain the rationale for these statements along the lines described in paragraphs 33-36.

Do you agree?

Faithful representation and the enhancing qualitative characteristics

Exposure Draft proposals

38. The Exposure Draft discussed how the other qualitative characteristics should be considered in the selection of a measurement basis.

39. It noted that faithful representation:

- (a) does not require that measurements should be ‘perfectly accurate in all respects’ but would be compatible with the use of estimates; and
- (b) may require the use of a similar measurement basis for related assets and liabilities to avoid accounting mismatches.

40. The Exposure Draft also noted that:

- (a) comparability implies that it is preferable to use the same measurement basis for different periods and different entities;

- (b) verifiability implies that it is preferable to use measurement bases that can be independently corroborated. If they cannot be independently corroborated, disclosures may be necessary or a different measurement basis may need be selected; and
- (c) understandability can be affected by the use of different measurement bases and changes in them.

Feedback from respondents

- 41. Many respondents agreed that the qualitative characteristics should be considered in the selection of a measurement basis. There were no major comments on the discussion in the measurement chapter of faithful representation or the other qualitative characteristics.

Staff analysis and recommendation

- 42. As noted in paragraph 1–2 of this paper, respondents to the Exposure Draft were disquieted that the linkage between ‘measurement bases and the information they provide’ (paragraphs 6.4–6.47) and the ‘factors to consider’ was not clear (6.48–6.63). Proposals to meet this concern, by stating more explicitly the implications of some of the factors have been set out above. These all relate to the selection of the most relevant measurement basis.
- 43. We think it is important that the measurement chapter should retain the discussion of faithful representation and the enhancing qualitative characteristics. However, it is questionable whether their implications need to be explicitly discussed, as they are considered after the most relevant basis has been selected.
- 44. The Exposure Draft stated in paragraph 6.49 that:
 - For information provided by a particular measurement basis to be useful to the users of financial statements, it must be relevant and it must faithfully represent what it purports to represent. In addition, the information provided should, as far as possible, be comparable, verifiable, timely and understandable.

45. Chapter 2 of the Exposure Draft (paragraph 2.21) emphasises the importance of relevance. It states:

The most efficient and effective process for applying the fundamental qualitative characteristics would usually be as follows (subject to the effects of enhancing characteristics and the cost constraint, which are not considered in this example). First, identify an economic phenomenon that is capable of being useful to users of the reporting entity's financial information. Second, identify the type of information about that phenomenon that would be most relevant if it is available and can be faithfully represented. Third, determine whether that information is available and can be faithfully represented. If so, the process of satisfying the fundamental qualitative characteristics ends at that point. If not, the process is repeated with the next most relevant type of information.

46. It would be helpful to cross-refer to paragraph 2.21 of the Exposure Draft early in the 'factors to consider' section. It could then explain that the selection of a measurement basis should proceed by identifying the measurement basis that provides the most relevant information, and then consider whether the result of applying that measurement basis can be faithfully represented: if it cannot be faithfully represented, the process should be repeated with the next most relevant measurement basis.
47. This would enable the implications of the 'factors to consider' to be confined to those that affect relevance: while the *Conceptual Framework* would also note the importance of faithful representation and the enhancing qualitative characteristics, their implications would not be explicitly addressed. In the staff's view this is the best option. Including a fuller discussion of the implications of faithful representation and the enhancing qualitative characteristics might either simply state the obvious or incur the risk of suggesting that specific requirements would be adopted in Standards, without an adequate consideration of relevance and the other qualitative characteristics. Therefore, the staff believe that the *Conceptual Framework* should not go further than the Exposure Draft in stating the implications of the enhancing qualitative characteristics.

Question 4

We recommend that the *Conceptual Framework* should retain the discussion in the Exposure Draft of faithful representation and the enhancing qualitative characteristics, but should not attempt to provide examples of their implications in specific cases.

Do you agree?

Other factors

Exposure Draft proposals

48. The Exposure Draft also stated that:
- (a) when selecting a measurement basis, it is important to consider what information that basis will produce in the statement of financial position and the statement(s) of financial performance;
 - (b) cost constrains the selection of a measurement basis. The benefits to users of the information provided by a particular measurement basis must be sufficient to justify the cost of providing that information; and
 - (c) the level of measurement uncertainty is a factor affecting the relevance of the information provided by a measurement basis. A high level of measurement uncertainty does not prevent the use of an estimate that provides the most relevant information; however, in some cases the level of measurement uncertainty is so high that a different measurement basis may provide more relevant information. The Exposure Draft also contrasted measurement uncertainty and outcome uncertainty.

Feedback from respondents

49. Few respondents commented specifically on these points, and this seemed to indicate general acceptance. Some responses, however, made suggestions that will be considered in the drafting process.

Staff analysis and recommendation

50. We consider that the points summarised in paragraph 48 above are important and should be retained in the *Conceptual Framework*. To be consistent with the Board’s tentative decision at its May 2016 meeting, the Exposure Draft’s discussion of measurement uncertainty should be revised to address it as an aspect of faithful representation rather than relevance.